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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF HAWAII

----In the Matter of ----)
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PUBLIC UTILITIES COMMISSION) DOCKET NO. 05-0002
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Instituting a Proceeding to Investigate)
the Issues and Requirements Raised)
by, and Contained in, Hawaii Revised)
Statutes 486H, as Amended.)
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TESORO HAWAII CORPORATION'S

RESPONSE TO ORDER NO. 22056

EXHIBIT A

AND

CERTIFICATE OF SERVICE

CRAIG I. NAKANISHI
SHAH J. BENTO
Rush Moore LLP
A Limited Liability Law Partnership
737 Bishop Street, Suite 2400
Honolulu, Hawaii 96813
Telephone: (808) 521-0400

Attorneys for
TESORO HAWAII CORPORATION

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TESORO HAWAII CORPORATION'S RESPONSE TO ORDER NO. 22056

Tesoro Hawaii Corporation ("Tesoro Hawaii") hereby respectfully submits its Response to Order No. 22056, Docket No. 05-0002 (filed on September 28, 2005) ("Order No. 22056").

I. SUMMARY

By Order No. 22056, the Public Utilities Commission of the State of Hawaii ("Commission") required the parties to submit (1) a marketing margin proposal further refining the class of trade approach suggested by ICF Consulting, LLC ("ICF") or any other more appropriate marketing margin proposal based on suitable benchmarks consistent with Hawaii Revised Statutes ("HRS") Chapter 486H, and (2) a proposal to adjust the HRS § 486H-13 wholesale gasoline price cap factors to include the addition of ethanol blending requirements. [1]

[1] Order No. 22056 at 3. The parties to this proceeding are Chevron U.S.A. Inc. ("Chevron"), Tesoro Hawaii Corporation, Hawaii Petroleum Marketers Association ("HPMA"), and Shell Oil Company ("Shell"). The Department of Commerce and Consumer Affairs, Division of Consumer Advocacy ("Consumer Advocate") is a party to this proceeding by application of Hawaii Administrative Rules ("HAR") § 6-61-62.

Marketing Margins

Tesoro Hawaii firmly believes that Hawaii's gasoline price cap regime cannot be fixed through the addition of layers of marketing margin price caps. Rather, additional marketing margin factors will detrimentally impact distribution.[2] In particular, a bulk sales cap does not further the intent of the legislature that prices reflect and correlate with competitive market conditions. Likewise, Dealer Tank-Wagon and Rack sales should not be subjected to price caps. Tesoro Hawaii urges the reinstitution of Hawaii's free-market forces in all marketing margin classes of trade.

Ethanol Adjustment

Tesoro Hawaii believes that an ethanol adjustment at this time is premature as there is enormous uncertainty surrounding the costs and pricing for ethanol, whether imported to Hawaii or locally produced. Currently, there is insufficient local supply of ethanol available to meet the State's needs and it is anticipated that there will be no local supply when the ethanol mandate is implemented.[3] Ethanol will need to be imported, to the consumer's detriment, adding one imported fuel to another. This lack of an assured supply, especially in tandem with complicated distribution problems, could lead to gasoline supply disruptions.

With respect to the pricing of ethanol, mainland[4] markets have no application to Hawaii and should not be used as "proxies" for local markets. Hawaii's administrative rules governing the pricing of ethanol are also of no help because they conflict with essential cost considerations

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[2] Moreover, the classes of trade currently being contemplated by the Commission may not be covered by Section 486H-13 of Hawaii Revised Statutes.

[3] Tesoro Hawaii believes that the State should immediately suspend the ethanol mandate for at least 24 months based on, among other items, the logistical challenges associated with factoring in the impact of ethanol into the gasoline price caps. This is due, in part, to the fact that the absence of local production means 100 percent of the ethanol will be imported and therefore the associated details and costs are unclear. While suspending the ethanol mandate falls outside of the purview of the Commission, Tesoro Hawaii respectfully urges the Commission to make such recommendations and take such actions as may be consistent with the recognition that the State is not yet ready for implementation of the ethanol mandate.

[4] The term "mainland" refers to the contiguous states of the continental United States.

for ethanol use in Hawaii. Although recovery is needed, a price cap factor for ethanol will compound the complexity and unworkability of the wholesale gasoline price cap. The free-market should control the recovery of costs associated with the ethanol mandate. Tesoro Hawaii strongly urges the reinstitution of free-market forces to recover the additional costs of compliance with the State's ethanol mandate.

Finally, while Tesoro Hawaii finds untenable any proposal that introduces another set of wholesale price caps into the gas cap regime or an ethanol adjustment at this juncture, Tesoro Hawaii respectfully requests that, similar to the procedure to comment on the ICF report, if the Commission deems a proposal to be appropriate, that Tesoro Hawaii be permitted sufficient time to examine and question any proposals put forth and to respond formally to such proposals before such proposals go into effect.

II. MARKETING MARGIN

A. Introduction

By Order No. 22056, the Commission required the parties to submit a marketing margin proposal further refining the class of trade approach suggested by ICF or any other more appropriate marketing margin proposal based on suitable benchmarks consistent with HRS Chapter 486H.

The Commission's current requirement for marketing margin proposals from the parties has as it genesis Decision and Order No. 21952, Docket No. 05-0002 (filed on August 1, 2005) ("D&O 21952").[5] In D&O 21952, the Commission addressed ICF's conclusion that the various

[5] The Consumer Advocate, HPMA and Shell made recommendations to the Commission regarding marketing margin adjustments in their position statements filed on July 1, 2005. However, the Commission did not address these recommendations and opted to request that the parties submit their proposals for study and refinement at this time. Order No. 22056 at 2.

classes of wholesale trade (e.g., Bulk, Rack and Dealer Tankwagon ("DTW")) cannot be regulated under one common margin.[6] The Commission took note of ICF's observation that there can often be multiple wholesale transactions prior to delivery to a service station and ICF's assertion that the wholesale price must be high enough to cover the cost of the product and the cost of marketing.[7] ICF initially argued for a cap on Bulk sales "to provide a margin incentive for importing."[8] ICF also proposed a Branded Rack cap based on average U.S. mainland Rack prices in eight cities in eight states.[9] Its proposed Unbranded Rack cap was based on Unbranded Rack prices in five cities in five states. ICF used five different cities in five different states to determine DTW prices. ICF then arbitrarily doubled the DTW and Rack margins to "allow for flexibility in setting prices and responding to market conditions."[10]

The ICF Report assigned price factors to marketing margins according to the classes of trade as follows:

> Bulk (1 cent per gallon ("cpg") above import parity),
> Rack (Branded) (6.7 cpg),
> Rack (Unbranded) (9.7 cpg), and
> Dealer Tankwagon ("DTW") (15 cpg).[11]

However, following the issuance of the ICF Report, in response to the information requests of the Consumer Advocate, ICF reversed its position on the need for a Bulk sales price cap of 1 cpg above import parity in Hawaii.[12] Currently, ICF recommends not imposing any gas caps on the Bulk class of trade.

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[6] *Implementation Recommendations for Hawaii Revised Statutes Chapter 486H, Gasoline Price Cap Legislation*, ICF Consulting, LLC (April 15, 2005) ("ICF Report") at 2.
[7] *ICF Report* at 2, 29-34.
[8] *ICF Report* at 34.
[9] *ICF Report* at 35-40.
[10] *ICF Report* at 42-43.
[11] *ICF Report* at 39-40, 43, 66.
[12] *ICF Response to Division of Consumer Advocacy's Information Requests*, Docket No. 05-0002 (May 17, 2005) (hereinafter referred to as "ICF's Response to Consumer Advocate") at CA-IR-8.

In D&O No. 21952, the Commission concluded that the ICF proposed class of trade approach was reasonable, but rejected ICF's methodology.[13] The Commission expressed a number of serious concerns, among them its concern with the selection of the geographic locations used in creating the margins for the different classes of trade and the doubling of the average margins of the selected locations.

As stated above, ICF's proposed caps on marketing margins are based on estimates of U.S. mainland margins.[14] First, the Commission concluded that while this could be a reasonable approach, ICF used different benchmarks for its proposed gas caps, primarily different states and cities. Second, the Commission was concerned about the selection of various benchmark markets, which were limited to certain markets with wholesale Rack pricing, and also to areas served by conventional gasoline. ICF could have identified U.S. markets that have significant dealer operated networks or included markets with divorcement laws similar to Hawaii, but it did not. Moreover, consideration was not given to the impact of real estate costs and rent caps. Third, ICF's doubling factor methodology did not appear to the Commission to be based on any objective rationale. The Commission found that this doubling factor methodology was not supported by any credible data or information in the record. Lastly, the Commission concluded that if some recommendations are adopted and not others, it could make matters worse for the jobber industry as a whole.[15]

Accordingly, the Commission concluded that it should initially use the HRS Chapter 486H method of adding 18 cpg for the marketing margin to implement HRS Chapter 486H rather than ICF's recommended methodology. While the HRS Chapter 486H approach does not take into account the different classes of trade, the Commission found "maintaining the flexibility of

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[13] D&O No. 21952 at 21.
[14] D&O 21952 at 22 citing ICF Report at 29-47.
[15] D&O 21952 at 22-24 (citations omitted).

marketers within one wholesale cap is preferable than creating a rigid price structure based on a questionable set of wholesale price caps in the various classes of trade."[16] The marketing margin factor from HRS § 486H-13(e) is set at 18 cpg for all classes of trade and is now being implemented by Hawaii's wholesale gasoline price cap law.

B. Marketing Margin Proposals Increase Risk

1. The Marketing Margin Factor Cannot be Corrected

Hawaii's gasoline price cap law is unworkable and fatally flawed. Price caps harm the vital local petroleum industry and Hawaii's consumers. Since the September 1, 2005 implementation date of wholesale gasoline price caps in Hawaii, Hawaii's consumers have experienced average retail gasoline prices that are higher than they were before regulation. Indeed, because of the gasoline price caps, Hawaii's consumers have borne the brunt of some of the highest average gasoline prices ever experienced in the State. Retail prices for gasoline have displayed high volatility with wide swings from week-to-week and sometimes day-to-day. Service station owners and operators have struggled in an effort to keep pace with the "virtual" market as consumers and retailers seek to "game" the system. Price controls such as the gas cap artificially interfere with the market process and have historically created supply problems and consumer hardships. Consumers create "runs" on lesser-priced gasoline based solely on price signaling by the Commission and media. Indeed, the media recommends to the public when to purchase their gasoline. The Hawaii public has changed its driving habits. Gas theft has increased. People drive "on fumes" to make it to the next predicted downturn in wholesale pricing only to find that retailers have not dropped their prices significantly. Retailers are also planning their sales and purchases to capture the most profitable marketing margins. Supply disruptions have already occurred.

[16] D&O 21952 at 21.

Tesoro Hawaii, ICF, the parties, and the Commission, all warned that some or all of these impacts could occur, and they have. Tinkering with the marketing margin formula will not address these overarching serious problems with the gas cap law.

2. Adding Marketing Margin Factors Detrimentally Impacts Distribution

Proposals to add more multiple price caps for classes of trade within the marketing margin will only make matters worse. In addition to increasing complexity and volatility in the marketplace, the ICF classes of trade approach, and any approach similar to it, will continue to distort the fundamental law of supply and demand. For example, as noted by Chevron, "[I]f gasoline marketers in Hawaii find that, under the proposed caps, some distribution channels do not provide an economic return, they will need to reduce or eliminate sales through those channels."[17] The result is that some distribution channels will benefit at the expense of others. A more serious effect could be the elimination of distribution in certain uneconomical channels to the detriment of consumers of that product.[18]

3. Section 486H-13 Does Not Contain Other Marketing Margin Factors

The law as written does not address parsing through classes of trade within the marketing margin as contemplated by the Commission. Section 486H-13 simply provides: "The marketing margin factor...shall be $.18 per gallon or as otherwise determined by the commission...." The creation of entirely new factors for different classes of trade or categories appears to fall outside of the law as contemplated by the legislature. There is no indication from the legislative record that the legislature intended to create wholesale gasoline categories that differ from those that are specifically set forth in HRS Chapter 486H. A Commission-initiated imposition of differentials between different categories or classes of wholesale trade appears to be outside of the four

[17] *See* "Report of Dr. David J. Teece," *Chevron U.S.A. Inc.'s Position Statement*, Docket No. 05-0002 (July 1, 2005) (hereinafter referred to as "*Chevron's Position Statement*") at 36.
[18] *Id.*

corners of this law. Furthermore, other than arbitrarily benefiting one sector of the industry over another, there is no underlying economic rationale for such a structure. Adding more price caps does not bring Hawaii any closer to "wholesale gasoline prices that reflect and correlate with competitive market conditions."[19]

4. Negative Consequences of Adding More Marketing Margin Factors

As noted by the Commission in D&O No. 21952, gasoline price caps by definition constrain prices and as a result, businesses operating under price caps may not be able to earn normal returns.[20] Any marketing margin factor proposals that the Commission considers will suffer from this problem. Under such conditions, gasoline supply shortages and product outages at service stations can occur. This situation will be exacerbated by any refinery outages since the gas cap will constrain the willingness of importers to import, or exporters to ship, product to the islands.

If the State's refiners cannot earn a fair return on investment then the viability of the industry will be threatened. As Chevron's economist observed, "[T]he on-island refiners may find imposition of the caps reduce their profitability to the point that it no longer makes economic sense for them to refine gasoline on the island."[21] Inadequate returns on investment will not induce refiners and others in the petroleum industry to invest capital in the State's petroleum infrastructure. If better returns are obtainable elsewhere, prudent business decision-making will naturally redirect investment to those areas. Hawaii is fortunate to have two refineries which increase the security of the local supply, even during periods of tight supply. However, price controls threaten that security by placing an artificial limit (price) on supply that

[19] *See* HRS § 486H-13(b).
[20] D&O 21952 at 35 (citing *Chevron's Position Statement* at 34).
[21] *Chevron's Position Statement* at 34.

will compete with higher-value opportunities outside the State of Hawaii. The end result could be gasoline shortages in Hawaii.

C. Tesoro Hawaii's Marketing Margin Position

Tesoro Hawaii would like to contribute to solving the State's gasoline price cap problems in the context of a marketing margin proposal. However, Tesoro Hawaii simply does not believe that price caps are good for Hawaii. Price caps are already hurting Hawaii consumers and the industry. The law cannot be fixed and should be repealed. That said, with respect to marketing margins, while the HRS Chapter 486H approach does not take into account the different classes of trade, the Commission found that maintaining the flexibility of marketers within one wholesale cap is preferable to creating a rigid price structure based on a questionable set of wholesale price caps in the various classes of trade.[22] Tesoro agrees that no price structure should be based on a questionable set of wholesale price caps.

Tesoro Hawaii finds untenable any proposal that introduces another set of wholesale price caps into the marketing margin based upon various classes of trade or on any other methodology. While Tesoro Hawaii does not agree that the gas cap law provides a workable formula, there are no alternatives that will work, other than Tesoro Hawaii's often-repeated proposal to restore normal market forces free of regulation. It is impossible for any proposal to contain essential free-market elements under the gasoline price cap regime. However, in an effort to mitigate the negative effects of regulation and to impart fairness, Tesoro Hawaii respectfully requests that it be permitted sufficient time to examine and question any proposals put forth and to respond formally to such proposals as may be deemed appropriate by the Commission.

[22] D&O 21952 at 21.

D. Bulk Sales

The Consumer Advocate observed in its Statement of Position that assigning a cap to the Bulk class of trade will cause pricing distortions and create numerous legal and technical issues with existing contractual agreements.[23] Tesoro Hawaii agrees.

ICF's recommended price cap for Bulk sales, which was calculated at "import parity" (plus 1 cpg) was based on the premise that Bulk sales are made at spot prices, as if a spot market in Hawaii exists.[24] Apparently, ICF at one time felt that there was a need to provide an incentive for importing. This ignores reality in Hawaii. Bulk sales occur between large purchasers and the refinery. Non-refinery wholesalers in Hawaii have the ability to negotiate an import parity price in Hawaii. This capability was most recently borne out in the recent Federal Trade Commission proceeding against Aloha Petroleum.[25] The ability to negotiate for and to obtain an import parity price in Hawaii already provides sufficient incentive for importing without the imposition of a Bulk sales price cap.

HRS Chapter 486H sets a single cap for wholesale gasoline sales. Although Tesoro Hawaii believes that gasoline price cap legislation is fundamentally flawed, a Bulk sales price cap merely further complicates an already unworkable law. Bulk sales account for 32 percent of refinery sales in Hawaii.[26] ICF could offer no reason for a Bulk sales price cap. There is no evidence to show that the Bulk price of gasoline is above a competitive level. Furthermore, refineries in Hawaii have made a significant investment in the islands not made by other oil companies and large terminal owners/distributors. The benefits of a Bulk sales price cap would

[23] *Division of Consumer Advocacy's Statement of Position*, Docket No. 05-0002 (July 1, 2005) (hereinafter referred to as "*Consumer Advocate's Statement of Position*") at 21.
[24] *See generally Chevron Position Statement* at 16.
[25] *See FTC v. Aloha Petroleum,* Civil No. 05-00471 (*D. Haw.* filed Jul. 27, 2005) (FTC moves to dismiss its complaint concluding marketers have the ability to import gasoline necessary to obtain a competitive bulk supply price).
[26] *ICF Report* at 30; *see also Chevron Position Statement* at 16.

flow only to non-refiner Bulk purchasers of wholesale gasoline and would constitute a windfall that was unintended by the Hawaii legislature. This benefit would not flow to Hawaii consumers.[27]

The Consumer Advocate and Chevron both recommend that the notion of a Bulk sales price cap be eliminated.[28] Tesoro Hawaii continues to believe that price caps associated with marketing margins, and in particular Bulk sales, cannot and do not reflect costs of operation in Hawaii. As stated in the Position Statement of Tesoro Hawaii Corporation, Docket No. 05-0002, (filed on July 1, 2005), marketing margin caps are "unacceptable to Tesoro Hawaii in view of the fact that they cannot and do not reflect and correlate with competitive market conditions in Hawaii."[29]

As stated above, ICF has reconsidered the position that it took in the ICF Report with respect to a discrete gasoline price cap on Bulk sales. Following the issuance of the ICF Report and technical meetings with the parties, ICF recommended <u>not</u> imposing gas caps on the Bulk sales class of trade. In ICF's reconsidered opinion, a Bulk sales cap would not further the intent of the gas cap legislation.[30] Tesoro Hawaii concurs.

C. <u>Rack and DTW Sales</u>

With respect to Rack and DTW sales, ICF proposed wholesale prices based on average prices reported for certain geographic areas that it chose on the mainland. To the extent that the parties' proposals adopt or refine the ICF class-of-trade approach, they will suffer from the same defects. No matter how carefully one selects "proxy" markets for Hawaii, the economic experiment will fail. Furthermore, even if the benchmarks could be aligned as much as possible

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[27] *See Chevron Position Statement* at 17.
[28] *See Chevron Position Statement* at 17; *Consumer Advocate's Statement of Position* at 21.
[29] *Tesoro Hawaii Statement of Position* at 16.
[30] *See ICF's Response to Consumer Advocate* at CA-IR-1 & -8.

with conditions in Hawaii, they can never substitute for a free market that reacts to the variable costs of operating a refinery in Hawaii market conditions.

ICF's methodology was developed by an independent professional petroleum consultant. Yet, the best method that the Commission's professional consultant could come up with proved to be extremely problematic and was rejected by the Commission. Any method that a party might propose would arguably be just as flawed. No geographic cross-section can ever recognize Hawaii's unique local supply and demand factors that affect prices and margins. As pointed out by Chevron: "In 2002, the rack margin in Seattle was approximately 21 times the margin in Tampa; in 1999 the rack margin in Phoenix was approximately 6 times the margin in Albany; and in all the years for which ICF reported DTW margins, the margins in Maine were higher than any of the other states that ICF included in its set of selected Hawaii benchmarks."[31] The data is entirely inconsistent and amply evidences the unworkability of an ICF-type approach that would seek to match Hawaii up with benchmarks on the U.S. mainland.

Ultimately, although the following list is by no means all-inclusive of the problems, Tesoro Hawaii believes that an ICF-type of approach to marketing margins, no matter how refined, will suffer from some or all of the following defects:

Inconsistency among benchmarks,
Contradictory data,
Different gasoline product composition,
Different classes of trade usage,
Different percentages of trade,
Inability to factor in Acts of God or other unforeseen events,
Inability to factor the lack of spot markets in Hawaii,
Inability to factor the lack of inter-market pipelines in Hawaii,
Different slates of product,
Different supply and demand patterns, wholesale and retail,
Inapplicability of averaging as a valid economic rationale,
Arbitrary adjustments to benchmarks,
Lack of state-to-state correlations between wholesale and retail margins,

[31] *Chevron Position Statement* at 21.

Increased complexity, substantial monitoring and enforcement costs,
Increased public and seller confusion about the price of gasoline,
Contractual and other legal difficulties,
Impact of Hawaii rent caps and land values,
Impact of Hawaii encroachment/divorcement requirements,
Different costs of living and taxes,
Different buying patterns and inventory,
Unknowable ethanol requirements and impacts, and
Increased price volatility and market risks.

Non-refiner parties may seek special margins that by their nature can only benefit one particular wholesale portion of the petroleum business. Although multiple wholesale sales take place, there is no reason to believe that an attempt to regulate each such transaction will be economically rational, fair, predictable, and also benefit the Hawaii consumer. Such an attempt will come at the expense of other wholesalers and the refiners who have made significant investments and commitments to operate in Hawaii. Tesoro Hawaii believes that legally mandating less marketing margin to one wholesaler and more to another is fundamentally unfair and not part of the statutory scheme laid out in HRS Chapter 486H.

III. ETHANOL REQUIREMENTS

A. Introduction

Hawaii's ethanol blending law requires "at least eighty-five per cent of all gasoline supplied to a retailer, sold at retail, or sold to a private, state, or municipal fleet for use in motor vehicles, and intended as a final product for fueling motor vehicles in the State of Hawaii, shall contain ten percent ethanol by volume."[32] The law goes into effect in April of 2006. By Order No. 22056, the Commission requires the parties to submit a proposal to adjust the HRS § 486H-13 wholesale gasoline price cap factors to include the addition of ethanol blending requirements.

[32] Haw. Admin. R. § 15-35-3 (2004); *see also* Haw. Rev. Stat. § 486J-10 (hereinafter referred to as the "ethanol mandate").

The intent of the ethanol mandate as originally passed by the legislature more than 10 years ago was to promote the sugar cane industry in Hawaii. Commitments have been made by the ethanol industry to construct facilities to produce ethanol in Hawaii; however, little or no in-state production will be on line by April 2006. Tesoro Hawaii has testified in support of the ethanol mandate if in-state production is on line and there is a benefit to the State. Under the circumstances, Tesoro Hawaii believes the State should suspend the ethanol mandate for at least 24 months based on, among other items, the logistical challenges associated with factoring in the impact of ethanol into the gasoline price caps.

B. Tesoro Hawaii's Ethanol Mandate Factor Position

Notwithstanding its strong opposition to price controls of any type, Tesoro Hawaii desires to contribute in a constructive way to the Commission's ongoing proceedings in this docket. Introduction of ethanol into the Hawaii gasoline market will require an additional level of difficulty to be added to an already complex gasoline price cap structure. In addition to the multiple zones and multiple distribution costs, each zone will also require a separate pricing structure for any ethanol blended fuel present in the market. This pricing structure will need sufficient flexibility to adjust for the cost of ethanol, location differentials to Hawaii from the source of the ethanol, re-distribution of the ethanol to many other outlying areas and the special infrastructure required to assure the quality of the ethanol and the blended fuel.

One of the key factors in any cost-recovery mechanism will be the availability of a sufficient supply of competitively priced ethanol, which for the foreseeable future, is by no means assured. For a variety of reasons, the costs of acquisition, delivery and blending of ethanol into Hawaii's gasoline stocks are high. In addition, many aspects of the ethanol mandate are difficult to determine. Under the circumstances, Tesoro Hawaii respectfully submits that it is unable to present a proposal that is sufficiently rigorous and reliable to be informative and helpful to the Commission. Indeed, Tesoro Hawaii itself is not in a position to assess fully the potential impacts of the ethanol mandate or to understand all of its associated capital costs, engineering demands, distribution requirements and other hardships. Tesoro Hawaii respectfully requests that it be permitted sufficient time to examine and question any ethanol mandate proposals put forth by the parties and to respond formally to such proposals as may be deemed appropriate by the Commission.

C. There is Enormous Uncertainty Surrounding the Costs and Pricing of Ethanol

The Commission appropriately observed: "Compounding the uncertainty of the gas price cap impacts are State ethanol blending mandates that go into effect in April 2006. ICF noted that the impacts of ethanol blending are clearly a factor that may need to be considered by the commission in future gas cap administration. It also expressed concerns...that 'the marketers, refiners, and consumers in Hawaii may be approaching a confluence of regulatory actions involving both the gas caps and ethanol which will likely create high business and capital investment uncertainty, as well as possible supply concerns.'"[33] All parties recognize the problems posed by the ethanol mandate. ICF notes that until the ethanol mandate is in place and a stable supply of ethanol in Hawaii is assured, it recommends that the caps be "initiated on a 'calculation and monitoring' basis."[34] To effectively incorporate the ethanol mandate into the existing gasoline price cap structure, it will be necessary to understand the costs of the ethanol itself, the distribution costs associated with movement of ethanol into each terminal and the infrastructure costs required to implement the ethanol mandate. It may be tempting to sidestep these issues by adjusting the existing gasoline price cap formula to include postings for mainland

[33] D&O 21952 at 38.
[34] *See ICF's Response to Consumer Advocate* at CA-IR-1 & -5; *see also* Chevron Position Statement at 4.

locations selling ethanol blended fuel, however that would be ill-advised for the many reasons discussed below.

1. Mainland Markets for Ethanol Blended Fuel Have No Application to Hawaii

In Hawaii, 85 percent of the gasoline is intended to contain 10 percent ethanol by volume.[35] Tesoro Hawaii believes that there is a strong potential that some markets in Hawaii will have ethanol, while others will not.

In contrast to the large monolithic mainland markets, Hawaii's markets are fragmented and disproportionately small. For instance in Minnesota, California, and other mainland markets, there is a broad availability of ethanol. Very large producers on the mainland manufacture ethanol. Significant terminal infrastructure investment has been made in markets such as California to move ethanol from the Mid West manufacturing centers in large rail shipments. Alternatively, imported ethanol is available and the mainland market is sufficiently large that commercially viable marine cargoes of ethanol can be purchased. The mainland ethanol prices are driven by factors outside of the Hawaii sphere of interest such as corn prices and natural gas prices.

The mainland gasoline markets which blend ethanol are not faced with the gasoline distribution challenges encountered in Hawaii. The gasoline Before Oxygenate Blend ("BOB") material is shipped to large terminals by efficient pipeline systems from the refineries. Ethanol is moved to the terminals in commercially significant quantities through a variety of reliable supply sources. There are many efficiencies of scale which will never be realized in the Hawaii market

[35] The current gasoline blends in Hawaii have a maximum vapor pressure limit of 11.5 psi. Ethanol addition will boost the vapor pressure of the gasoline by approximately 1 psi. Therefore, it is necessary to reconfigure refinery gasoline blending to prepare a base gasoline blendstock that can accommodate the addition of 10% ethanol without exceeding the regulatory vapor pressure cap. This special blendstock is referred to as "Before Oxygenate Blend" or "BOB."

environment and therefore it would be invalid to assume that a mainland price for ethanol blended fuel is directly applicable to the Hawaii situation. Moreover, many mainland states have had years of experience with ethanol while Hawaii has had none. None of these mainland markets are subject to the multiple wholesale gasoline price controls that are in place in Hawaii.

While there are simply too many unknowns in Hawaii, one thing is clear: Hawaii's unusual market configuration, complicated distribution requirements over water, and gasoline price caps take this State's markets far outside of any meaningful comparison with those on the mainland.

2. Hawaii's Administrative Rules for Pricing of Ethanol are in Conflict with the Costs of Ethanol

Under HAR § 15-35-2, "competitively priced" ethanol means:

> [F]uel-grade ethanol CIF Honolulu terminal for which the wholesale price minus the value of all applicable federal, state, and county tax credits and exemptions, is not more than the average posted wholesale rack price of unleaded gasoline of comparable grade, as published by the U.S. Department of Energy, Energy Information Administration, in Petroleum Marketing Monthly, Table 31 and available on the Energy Information Administration website or as otherwise prescribed by the petroleum commissioner.

"'CIF Honolulu Terminal' denotes the quoted sales price of motor fuel, which includes the cost, insurance, excise tax, and freight charges to any terminal in Honolulu, Hawaii."[36]

The rules do not contemplate, and therefore do not address, what will happen to distributors who are required to comply with the ethanol mandate when the price of ethanol is greater than the average posted wholesale rack price of unleaded gasoline as published by the Energy Information Administration. The sole recourse available to distributors burdened by high ethanol prices or lack of supply is found in HRS § 486J-10, as implemented by Hawaii Administrative Rules §15-35-9:

[36] HAR §15-35-2.

> The petroleum commissioner may authorize the sale of gasoline that does not meet the requirement of ten per cent ethanol if the petroleum commissioner determines that
>
> (1) Sufficient quantities of competitively-priced ethanol are not available to meet the minimum requirements of this chapter; or
>
> (2) In the event of any other circumstances for which the petroleum commissioner determines compliance with this chapter would cause undue hardship.

However, this exemption mechanism is debilitating, cumbersome and slow. Even assuming distributors can anticipate supply or pricing problems and react quickly, it still takes up to 45 days to obtain a determination from the petroleum commissioner that an exemption, in whole or in part, will be allowed. If allowed, an exemption is only good for 90 days, subject to renewal. Ultimately, the exemption process does not meet the needs of a distributor to address potentially wide and rapid fluctuations in market prices of ethanol from day-to-day or week-to-week. Moreover, there is no capability at the refinery to "flip" operations, equipment, and distribution, from refining and blending BOB one week, to refining conventional gasoline the next week, and back again. Thus, the ethanol mandate places refinery operations in Hawaii at risk.

Alternatively, it appears that the petroleum commissioner can simply prescribe any price, deem it "competitive" and require distributors to buy the ethanol in order to comply with the ethanol mandate, no matter how high the price of that ethanol becomes. The ethanol administrative rules provide no check or balance against the petroleum commissioner's powers. Under this scenario, the ethanol mandate completely binds Hawaii's distributors and consumers to a price prescribed by regulation or the regulator. The normal mitigating forces of supply and demand, and the benefits of a free market, do not exist in this regulated environment. Regardless of what the Commission or the parties determine with respect to an ethanol factor in the price cap, prices of ethanol are subject to the control of State ethanol regulations and the petroleum commissioner.

As discussed herein, the actual costs of ethanol supply, delivery, blending, and distribution throughout the Hawaiian islands are, at best, vague. The price of ethanol does not move with the price of gasoline. Indeed, lack of any positive correlation could adversely impact the price of gasoline, i.e. when the public expects gas prices to be trending downwards, ethanol prices may be moving up.

Regardless of the conflicts inherent in the pricing mandates contained in HAR Title 15, Chapter 35, price caps cannot be reasonably calculated to cover unpredictable and fluctuating distribution costs. As explained below, distribution costs are further complicated by the need to transport ethanol over water to Hawaii, and throughout the island chain.

3. <u>Uncertainty Regarding Infrastructure Costs of Ethanol in Hawaii</u>

The distribution of ethanol within the State of Hawaii will present unique challenges. The particular properties of ethanol require that it be shipped and stored as a separate product until it is blended at the terminal racks on Oahu and the neighbor islands. Ethanol has an affinity to mix with water and must be handled with care to avoid contamination at each point in the gasoline distribution system.

Hawaii has sixteen terminals distributed across Oahu and the Neighbor Islands. Ethanol must be shipped to the truck loading rack from the point of production. Moving ethanol by barge to the gasoline distributors across large expanses of water while maintaining its integrity will be a challenge to participants at each level of the distribution system. Costs will be incurred not only by the terminal operators but also by trucking companies and individual service station operators who must maintain water-free equipment for ethanol blended fuel. Implementing measures to minimize this risk is an additional, expensive burden on terminal operators and all gasoline service station owners, large and small.

Much work has been done by Tesoro Hawaii to prepare for the advent of ethanol blending but the final capital costs for tankage, piping and segregated barge capacity are not yet available. An additional area of uncertainty is the concern over the availability of local ethanol. This has increased the cost of infrastructure as preparations are underway to import larger volumes of ethanol and to implement contingency plans for distribution of ethanol out to the neighbor islands to meet the ethanol mandate's requirements. These measures will lead to higher operating costs due to the specialized barging needs and the cost of carrying larger inventories of ethanol from imported cargoes.

4. The Ethanol Mandate Increases Costs at the Refinery

As stated above, Hawaii law requires 85 percent of all gasoline to contain ten percent ethanol by volume. As a result, Tesoro Hawaii could potentially need to refine four instead of the current two gasoline blends, as follows: (1) Regular Unleaded BOB; (2) Regular Unleaded Conventional; (3) Premium Unleaded BOB; and (4) Premium Unleaded Conventional. These duplicative infrastructure requirements could potentially multiply the capital and operational costs for the distribution system.

Additionally, the impact of the ethanol mandate on the local refining infrastructure is likely to be more severe here than elsewhere in the United States. Tesoro Hawaii's refinery will be adversely affected by both the cost to produce a low Reid Vapor Pressure ethanol BOB, and the resulting disposal of the displaced light naphtha component of the gasoline at reduced margins. Moreover, there is no benefit to Tesoro Hawaii from the low sulfur content of the ethanol since the gasoline manufacturing process at Tesoro Hawaii's refinery already produces an ultra-low sulfur gasoline product. In addition, the effect of introducing 10 percent ethanol blending into the gasoline pool may adversely impair the utilization of its manufacturing assets. All of these intangible costs are an inherent and important part of the many factors and issues that the Commission would be trying to accommodate.

D. The Free-Market Should Control the Recovery of Costs Associated with the Ethanol Mandate

In the context of conventional gasoline refining, with which Tesoro Hawaii has had much experience, the company continues to believe that government-dictated gasoline price caps do not work. The parties and various experts who have examined the concept have amply explained the problems which plague the imposition of a gasoline price cap. Unfortunately, the problems with the gas cap have been borne out in the marketplace today as Hawaii's consumers struggle with volatile gas prices wholly unrelated to local conditions and without the benefits of a free market.

With respect to gasoline blended with ethanol, Tesoro Hawaii agrees that there must be recovery for the additional capital costs associated with the ethanol mandate. However, Tesoro Hawaii firmly believes that restoration of the free market, not the addition of more price caps, is the best public policy for the State of Hawaii.

While Tesoro Hawaii understands the importance of ethanol to the agricultural segment of our State, it is equally important to the State that the petroleum industry remains strong and viable. Tesoro Hawaii has concluded that ethanol blending into gasoline will cause substantial capital, manufacturing and operational issues for Tesoro Hawaii. Ethanol blending into gasoline in Hawaii presents unique challenges versus the comparable situation on the mainland because of our geographic isolation. Without assistance for the capital burden of the ethanol program, ethanol implementation measures will cause an upward pressure on gasoline prices in Hawaii.

E. <u>There is Significantly Insufficient Local Supply Available to Meet the State's Needs</u>

1. <u>Hawaii Producers of Ethanol are Unable to Meet the Roll-out Date</u>

Tesoro Hawaii recognizes the effort that has gone into the developing an ethanol market for Hawaii. However, Tesoro Hawaii is concerned that there has been no local production of ethanol and no plants have yet been built.

For example, on September 23, 2005, the Pacific Business News carried an article entitled "Ethanol still a long way from the local pump" authored by Clynton Namuo. Mr. Namuo writes: "A year after the state passed rules requiring the use of 10 percent ethanol in gasoline, no ethanol production plants are even close to being built. That means that when the requirements take effect next April, Hawaii will have to import ethanol along with oil, adding another cost to the price of fuel." [37] The editor of Pacific Business News followed-up Mr. Namuo's report with an editorial entitled "Ethanol requirement should be postponed." [38]

Clearly, despite the best of intentions, Hawaii is not ready for ethanol. Hawaii law does not require local ethanol producers to provide a sufficient supply of ethanol to meet the mandated roll-out date, or even to forecast the availability of ethanol supply. The Western States Petroleum Association has concluded that: "There is no assurance that Hawaii will have a safe, reliable, economically viable source of ethanol. Even if current plans to produce ethanol are implemented at the pace predicted by ethanol industry members, there is no doubt that far less than half of the amount required would be produced in Hawaii." [39]

Tesoro Hawaii is concerned that without a reliable local supply of ethanol, the State will not realize the value of supporting the ethanol industry or any of the expected economic effects

[37] *See* Exhibit A, attached.
[38] *See* Exhibit A, attached.
[39] *See* "Testimony of Western States Petroleum Industry on Senate Bill 3170, Relating to Petroleum Products," April 21, 2004.

across the various related business sectors. Equally important, the intent of the gasoline price cap and the ethanol mandate are at cross-purposes. The ethanol mandate is pushing the cost of producing gasoline in Hawaii higher while at the same time Hawaii's wholesale prices are tied to average gasoline price markers outside of Hawaii that do not contain ethanol. While the temptation is to choose another mainland marker, this time for ethanol, for all of the reasons stated herein this choice would be critically flawed and lead to negative economic consequences for Hawaii.

According to the Department of Business Economic Development and Tourism, statewide about 450 million gallons of gasoline are sold per year.[40] Based on the 85 percent mandate, 38.25 million gallons of ethanol will be needed each year in Hawaii. Targeting for at least 38.25 million gallons of local ethanol production will dramatically increase the amount of local agricultural feedstock needed and will require a corresponding increase in local agricultural production to make up the difference. Thus far, Hawaii has not met this challenge. If out-of-state sugar is imported to manufacture ethanol, the State has not realized the benefit envisioned by the legislature and should re-evaluate the policy decision that mandates blending ethanol into gasoline in Hawaii.

2. Ethanol Will Need to be Imported to the Consumer's Detriment

Given Hawaii's current lack of a sufficient ethanol infrastructure, ethanol will need to be imported into the State for some time to come. This situation adds to the uncertainty surrounding costs. Unfortunately, while the Commission is seeking to develop these costs, Tesoro Hawaii respectfully submits that it just does not know what the elements of these costs will be or how it can conceivably be properly accounted for in a price cap regime. Any imported ethanol that arrives on Oahu, will need to be distributed throughout the islands and spread across

[40] *See* http://www3.hawaii.gov/DBEDT/index.cfm?section=SID1743.

eight zones under the wholesale gasoline price cap. It is simply not possible to manage ethanol distribution and blending throughout the islands, zone-by-zone, in a consistent manner that can be accurately accounted for through government-prescribed pricing factors.

It should not go unsaid that local agricultural benefits may not be realized in Hawaii. As it currently appears, only out-of-state or foreign ethanol producers will gain at the expense of Hawaii's residents and businesses.[41] Ethanol must be shipped and stored as a separate product until it is blended with gasoline at the terminal racks on Oahu and the neighbor islands. The unintended consequence is the promotion of imported out-of-state ethanol. In essence, one imported fuel is being replaced with another imported fuel.

Tesoro Hawaii believes that Hawaii will end up subsidizing out-of-state importation of ethanol on a large and perhaps permanent basis.

3. Lack of Local Supply Can Lead to Supply Disruptions

In other areas of the country that have introduced ethanol blending, the gasoline distributors have access to many alternate sources of ethanol available by truck or rail. Hawaii will be unique in implementing an ethanol mandate that is intended to be reliant upon local manufacturing capabilities without recourse to readily available alternate ethanol supplies. Tesoro Hawaii is very concerned about the potential for disruption to Hawaii's gasoline supply resulting from the unavailability of ethanol.

F. Implementation of the Ethanol Mandate is Unrealistic

In addition to the demands on capital, the implementation schedule is presenting significant challenges for engineering and permitting reasons. More specifically, the nature of

[41] Moreover, parties other than distributors produce ethanol. Tesoro Hawaii does not have oversight of the ethanol production facilities and is not involved in the quality control of the ethanol it receives. Accordingly, local distributors should not be held liable for any possible motor vehicle damages incurred as a result of the introduction of ethanol into the State's gasoline pool.

ethanol blending in gasoline requires that the ethanol be added at the terminal rack prior to distribution by truck. Consequently, each of Tesoro Hawaii's terminal facilities will require expensive modifications to facilitate ethanol blending. Significant efforts are required to provide ethanol storage and blending before the implementation date in April 2006. The prerequisite engineering and permitting will take many months, as will the construction of tankage, piping and blending facilities.

Typically, the petroleum industry requires three to four years to plan, budget and implement significant changes to its distribution systems. Although Tesoro Hawaii will endeavor to meet all requirements of the ethanol mandate, it must be emphasized that the implementation date is unrealistic and simply does not allow enough time for petroleum distributors to design, permit, and construct the tanks and associated facilities that are necessary to blend ethanol into gasoline.

IV. CONCLUSION

Tesoro Hawaii does not believe that the gasoline price cap law can be fixed. Rather, the entire experiment should be scrapped. Impacts from additional marketing margin price caps and ethanol requirements compound problems faced by Hawaii's suppliers and consumers already hard-pressed by price caps. Fundamentally, Tesoro Hawaii believes that price cap proposals will be inherently contrary to sound economic policy. The free market best addresses and advances Hawaii's economic future. Tesoro Hawaii strongly opposes gasoline price caps in Hawaii.

Finally, while Tesoro Hawaii finds untenable any proposal that introduces another set of wholesale price caps into the gas cap regime or an ethanol adjustment at this juncture, Tesoro Hawaii respectfully requests that, similar to the procedure to comment on the ICF report, if the

Commission deems a proposal to be appropriate, that Tesoro Hawaii be permitted sufficient time to examine and question any proposals put forth and to respond formally to such proposals before such proposals go into effect.

DATED: Honolulu, Hawaii, November 1, 2005.

RUSH MOORE LLP
A Limited Liability Law Partnership

Craig I. Nakanishi
Shah J. Bento

Attorneys for
TESORO HAWAII CORPORATION

EXHIBIT A

Pacific Business News

"Ethanol still a long way from the local pump"
(September 23, 2005)

"Ethanol requirement should be postponed"
(September 30, 2005)

Pacific Business News (Honolulu) - September 26, 2005
http://pacific.bizjournals.com/pacific/stories/2005/09/26/story3.html

PACIFIC BUSINESS NEWS

EXCLUSIVE REPORTS
From the September 23, 2005 print edition

Ethanol still a long way from the local pump

Clynton Namuo
Pacific Business News

At a time when $4 per-gallon gas has everyone looking for alternatives, Hawaii's efforts to produce ethanol are stalled.

A year after the state passed rules requiring the use of 10 percent ethanol in gasoline, no ethanol production plants are even close to being built. That means that when the requirement takes effect next April, Hawaii will have to import ethanol along with oil, adding another cost to the price of fuel.

Five ethanol plants on three islands have been proposed, but the earliest construction would start is next spring. State tax credits worth 30 cents for each gallon of capacity, totaling a maximum $4.5 million per facility, was supposed to spur construction, but financing problems, bureaucracy and design changes have stalled the projects.

State Rep. Cynthia Thielen, R-Kailua-Kaneohe Bay, a supporter of the ethanol initiative, said there is no excuse for the slow movement.

"With the crisis with oil prices, it's essential that ethanol producers move ahead now," she said. "These delays are unacceptable."

The credit is available for eight years and only for the first 40 million gallons of ethanol produced.

California-based Pacific West Energy plans to build two plants, one each on Kauai and Maui. Construction of the Kauai facility is set to begin in April 2006 with completion near the end of next year. It will produce 15 million gallons per year and be on land leased from sugar grower Gay & Robinson Inc.

Work on the Maui facility is expected to start in June 2006 and be finished in December. It will produce 12 million gallons per year and will be on land leased from Hawaii Commercial & Sugar, a division of Alexander & Baldwin Inc.

Both projects will use molasses, a byproduct of sugar refining, to produce ethanol. Construction has been delayed mostly by design changes, said William Maloney, chairman and president of Pacific West.

The Maui plant has been redesigned four times to make the ethanol production as efficient as possible. How much money Maui Ethanol can make depends on the facility's byproduct and what can be made from it, whether it be fertilizer, bio gas or animal feed. Animal feed was found to be the most profitable.

The Kauai facility has been equally affected by the design changes, but slowed further by funding and corporate issues, Maloney said. An investment group, whom Maloney declined to name, and Gay & Robinson still have not finalized funding of the project, which has slowed its start, he said, though the issues are expected to be resolved soon.

While Maloney said the state tax credits are "essential" to the Maui and Kauai projects, he's not worried about missing out on the first 40 million gallons of capacity.

Kauai and Maui plants

Hawaii-based ClearFuels Technology also is set to build two ethanol production plants, one each on Kauai and Maui. The company plans to use "biomass," or waste products from sugar and other plants, to make ethanol.

Construction on its Kauai plant is supposed to begin in March or April; no firm date has been set and the project has faced delays in obtaining financing, chief financial officer Eric Darmstaedter said.

Once operational, the plant will make 7.2 million gallons of ethanol per year and be on land leased from Gay & Robinson. Plans for the Maui facility are still in their early stages and no start date has been finalized. The plant will be on land leased from HC&S.

Despite delays, Darmstaedter said he isn't concerned about losing out on the tax credits to those who get their plants running first.

"Obviously, if you don't get the credit the financials aren't as attractive. It's a judgment call by investors," he said. "I'm not worried about it."

Hawaii-based Oahu Ethanol plans to build a plant at Campbell Industrial Park with construction beginning in the second quarter of 2006, according to a notice submitted to the state Department of Business, Economic Development and Tourism. The plant will produce 15 million gallons per year.

A company executive said only that the plant is in the permitting stage and declined to give further details.

In July 2004, Dan KenKnight of Oahu Ethanol told PBN, "I have my engineering completed and am poised to start with the permitting to build the plant."

Efforts by PBN to reach KenKnight for an update on the project were unsuccessful.

For Gay & Robinson, ethanol production is seen as the savior of the family-owned company, which runs one of the two remaining sugar plantations in Hawaii.

"Gay & Robinson cannot stay in the sugar business as a commodity supplier," said president and general manager Alan Kennett.

Gay & Robinson plans to become an energy company and use sugar and its byproducts not only to fuel the ethanol plants, but also a new and larger boiler it plans to build that would sell power directly to the grid on Kauai, Kennett said.

HC&S project engineer Lee Jakeway on Maui said that although the ethanol projects are not necessary to sustain the company, delays have not helped.

"We would like to have seen things go a little bit faster," he said.

Proponents had predicted ethanol production would be a thriving industry in Hawaii, generating $100 million in revenue and adding $300 million to the state's economy. Some experts say ethanol could lower the price of gasoline, while oil companies say that hasn't been the case on the Mainland, where ethanol has been used for nearly 30 years.

But the recent gas supply squeeze in the United States is expected to drive renewed interest in alternative fuels, such as ethanol.

cnamuo@bizjournals.com | 955-8001

Pacific Business News (Honolulu) - October 3, 2005
http://pacific.bizjournals.com/pacific/stories/2005/10/03/editorial2.html

PACIFIC BUSINESS NEWS

OPINION

From the September 30, 2005 print edition

Ethanol requirement should be postponed

We were enthusiastic a year ago this week when the state required that by April 2006, 85 percent of the gas sold in Hawaii contain at least 10 percent ethanol. A few months earlier, when the ethanol regulations were proposed, we said the decision was a "no brainer."

It turns out though, that neither PBN nor the Lingle administration was using at least the analytical part of our brains.

As reported by Clynton Namuo in PBN last week, not one of the five ethanol plants on three islands enthusiastically promised last year has even started construction.

That means Hawaii will have to import ethanol next year, at least at first.

Reluctantly, we suggest that Gov. Linda Lingle suspend the start date for implementing the ethanol requirement by one year, to April 2007. That should give at least some of the ethanol entrepreneurs time to get their plants up and running.

As described last year, the benefits of ethanol were intoxicating: $300 million a year to the state's economy, 200 new jobs and the promise of grabbing some of that elusive economic diversification. And if that wasn't enough, throw in the feel-good hope that ethanol could save the state's last two sugar plantations and cut our dependence on imported oil.

Developers of the ethanol plants projected there eventually would be 45 million gallons of ethanol produced annually, much more than the state indicated would be required. Under most of the plans, molasses or sugar cane fiber, both byproducts of the sugar-refining process, would be fermented and converted to alcohol.

We're still enthusiastic about the ethanol-gas mix concept for Hawaii. It does make sense. But for now, the requirement should be put on hold.

CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the foregoing Response of Tesoro Hawaii Corporation to Order No. 22056 upon the following parties, by causing a copy hereof to be mailed via U.S. Mail, postage prepaid, and properly addressed to each such party.

Department of Commerce and Consumer Affairs (2 copies)
Division of Consumer Advocacy
P.O. Box 541
Honolulu, HI 96809

Michael H. Lau, Esq.
Kent D. Morihara, Esq.
Ishikawa Morihara Lau & Fong, LLP
841 Bishop Street, Suite 400
Honolulu, HI 96813

Clifford K. Higa, Esq.
Bruce Nakamura, Esq.
Kobayashi, Sugita & Goda
First Hawaiian Center
999 Bishop Street, Suite 2600
Honolulu, HI 96813

Danny Batchelor
Senior Counsel
Shell Oil Company
P.O. Box 2463
Houston, TX 77252-2463

Kelly G. Laporte, Esq.
Marc E. Rousseau, Esq.
Cades Schutte LLP
1000 Bishop Street, Suite 1200
Honolulu, HI 96813

Dated: Honolulu, Hawaii, November 1, 2005.

Sue Iwashita

Sue Iwashita